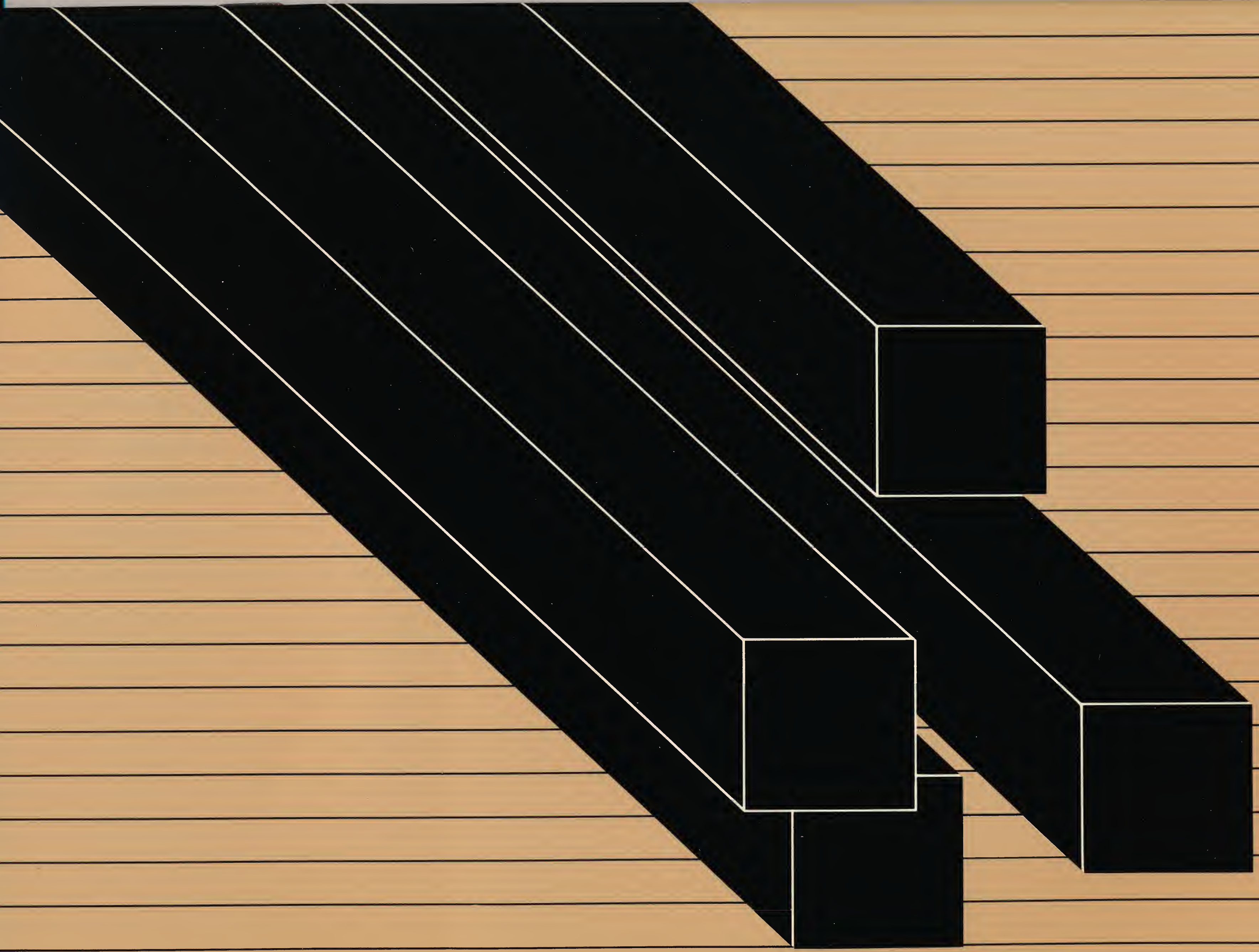


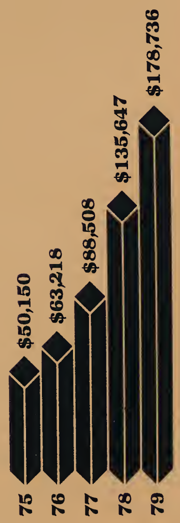
The opportunities that lie ahead require our commitment today.

**Four-Phase Systems, Inc. Annual Report 1979**

## Highlights

| | 1979 | 1978 | Increase |
|---|---|---|---|
| Revenues | **$178,736,000** | $135,647,000 | 32% |
| Net income | **16,727,000** | 12,196,000 | 37% |
| Net income per share (fully diluted) | **$3.25** | $2.58 | 26% |






**Revenues**
(Thousands)


**Net Income**
(Thousands)
Before
Extraordinary
Credit


**Net Income Per Share**
(Fully Diluted)
Before
Extraordinary
Credit

## Corporate Profile

Four-Phase Systems develops, manufactures, markets and services multifunction computer systems for distributed data processing applications. The Company's computers and associated higher level software support clusters of video workstations and are used primarily to enter data, manage and inquire into data files, process data locally and perform word processing. The large-scale integrated (LSI) semiconductor devices utilized in Four-Phase central processing units are of the Company's own design and manufacture.

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## To Our Stockholders:

The year 1979 was one of growth, accomplishment and challenge. It was a rewarding period and one in which we continued to focus on our longer-term goals balanced by current objectives.

Operating results again posted substantial gains. Revenues advanced 32% to $178.7 million compared with $135.6 million in 1978. Net income increased more rapidly, rising 37% to $16.7 million in 1979 from $12.2 million the prior year. Net income per share rose 26% to $3.25 fully diluted in 1978 against $2.58 a year earlier. The increase in per share income reflects the mid-1978 issue of 500,000 shares of Common Stock. Average shares outstanding increased by 9% in 1979.



A highlight of 1979 was the introduction of the Systems IV/60 and IV/65. These mid-range processors offer customers higher speed and greater processing power and extend the utilization of the Multifunction Executive, MFE/IV. The IV/60 and IV/65 have been received enthusiastically by our customers and are viewed as a significant addition to our product spectrum. Production shipments of these two processors commenced in the third quarter of 1979 and accelerated in the final period. A significant portion of future shipments will derive from this 1979 introduction.

Four-Phase in 1979 experienced increasing demand for multifunction systems, a capability we pioneered. This trend toward multifunction distributed processing was especially evident in the Systems IV/60 and IV/65 orders, which were predominantly for MFE/IV. In light of our experience in multifunction distributed processing, it is evident that the Company's position and strategy in this market was and is on target.

N.V. Philips of the Netherlands has been the Company's distributor in Western Europe since 1972. Our distribution contract with Philips was renewed in mid-1979 and extended five years through December 1984. We look forward to mutually favorable expansion of our European sales opportunities.

To meet the growth and management challenges that lie ahead we continued in the past year to build and refine our resources and capabilities. A very visible example of this commitment is the Field Engineering Operations Center, the hub of an on-line communications and control network that provides customers with more efficient field service response. The Operations Center is active around the clock, seven days a week, to provide our customers with the most responsive service feasible. It enables the Company to manage and allocate resources on a real-time basis and to obtain timely and accurate information vital to the management of the Company.

The Operations Center, a product of more than a year of intense development effort, is already proving its value to our customers and the Company. Consequently, we are proceeding with a phased plan that will add significantly to the Center's state of the art capabilities over the next several years. Other functional areas within the Company are engaged in comparable projects with both near-term and long-range goals and objectives.

The growth of a company operating in a lease-oriented marketplace requires a strong and stable financial base and the ability to expand upon that base when appropriate. In 1979, we further reinforced our financial position and flexibility.

Of major importance, we restructured and improved our $75 million bank credit facilities. The new bank agreement, entered into in March, provides for reduced interest rates relative to the prior agreement and greater financing latitude. These new provisions have been of particular benefit during the recent period of rising interest rates. The bank lending group, which has been intact for the past five years, includes four of the five largest banks in the United States. That fact, plus the long-term stability and integrity of the bank group, provides a high level of support in uncertain times.

Formation of our finance subsidiaries in late 1977 afforded the Company its first access to long-term fixed-rate debt. We took advantage of that capability in March 1979 by refunding $10 million of revolving debt into 10.25% Senior Notes with a final maturity in 1994. This interest rate proved especially favorable in the latter part of 1979 and will beneficially impact 1980 operations as well. The Company now has placed $30 million in fixed-rate long-term notes.



We are pleased to report that the Company's equity base rose by 30% in 1979 while long-term debt increased by only 19%. Stockholders' investment, as a result, comprised an increased portion of capitalization, exceeding long-term debt by 2.5 to 1 at 1979 year-end compared with 2.3 to 1 a year earlier. This puts the Company in its strongest financial posture yet.

In the latter part of 1979, we began construction of a fifth building in the Company's Cupertino administrative and manufacturing complex. This 210,000 square-foot office building will enable us to expand production in the present four-building plant first occupied in mid-1977. Building 5, located adjacent to the existing buildings, is scheduled for completion in the spring of 1981.

Looking forward, we enter the new decade with a strong leadership position in a rapidly expanding market. We are dedicated to competing effectively in the multifunction distributed processing industry and to achieving the longer-term growth such a stance implies. We have carefully structured our capabilities to provide the full range of distributed processing so vital to our customers. Our products have been designed and optimized for CRT-based distributed data processing applications and are time-tested in rigorous and diverse operating environments. Field support personnel ensure timely and professional customer assistance.

In planning for 1980, the Company envisions a recession in the United States. This is expected to moderate the firm's growth in revenues for a short period. However, in anticipation of strong long-term growth in distributed processing, the Company intends to proceed with a wide range of corporate development programs, including approximately a 50% increase in development and engineering expenditures. These investments in the future, made at a time of moderating revenue growth, are likely to affect net income in 1980. The longer-term result will be to build an even stronger Company positioned to enhance our important share of the dynamic growth forecast for the distributed processing market.

We owe our success to date to the high level of contribution, support and confidence of our employees, suppliers, customers and stockholders. To each we pledge our best efforts, the highest standards of personal and professional conduct, and our unceasing focus on our long-term interests in the ensuing years.

Sincerely,

Lee L. Boysel
President

January 23, 1980

## Investing in the Future

Investing in the future of Four-Phase, to position the Company for long-term growth and profit, is at the core of the Company's 1979 achievements and its 1980 plans. This sustained commitment is visible throughout the Company—in development funding, in new and improved products, in better customer support, in organizational development and in enhanced manufacturing methods. Our policies thus adhere to a basic goal: to excel in multifunction distributed processing through an integrated systems approach.



Helping our customers to manage their activities more effectively and profitably is our business. Distributed processing both speeds the flow of accurate information to central headquarters sites and provides operating management with access to real-time data pertinent to their needs. Large, decentralized organizations increasingly look to the information management advantages inherent in distributed processing to achieve operating efficiencies. Moreover, the power and versatility available in distributed processing have risen dramatically, a trend that is expected to persist, resulting in even more cost-effective systems. We are therefore addressing a market which is of very large potential size and one which is demanding and exacting in its requirements. To continue to succeed in this market, we will sustain and emphasize our balanced and consistent long-term approach.

Our optimism regarding the bright future in users' distributed processing requirements underlies the Company's investments in development across the spectrum of Four-Phase activities. Such development in conjunction with our evolutionary product strategy which permits users to upgrade their systems continuously, flexibly and economically will enable the Company to maintain a leading position in a dynamic industry.


*Four-Phase distributed processing systems meet the emerging requirement for multifunction capabilities in large, decentralized organizations.*

*Baldwin-United Corporation is a growth-oriented, balanced financial services company with assets of over $3 billion. The four principal areas of operations are insurance, savings and loan, banking and musical instruments.*

*The increasing power and capability of Four-Phase products has responded to Baldwin's expanding information processing needs over more than five years. Baldwin initially installed a network of System IV/40s within its Piano and Organ Division. These sites have been upgraded to our larger software-compatible System IV/90's as more applications were added. Distributed processing has enabled Baldwin Piano and Organ to achieve manufacturing efficiencies through improved labor and material utilization and better inventory control while shortened billing cycles enhance profitability.*

*Baldwin in 1979 added multifunction distributed processing capabilities on our new System IV/65. The versatility available within a multifunction environment is especially suited to the growing, evolving nature of Baldwin-United.*

The large, sophisticated organizations we serve expect continually improving results from our systems. They seek higher efficiency and productivity in an era where management skill and control is at a premium. Our systems pace these expectations, and thus create future customer demand. Several valuable enhancements in 1979 enable our systems to work harder at lower relative cost—thus more efficiently. A planned increase of approximately 50% in systems development and engineering outlays in 1980 will generate powerful future capabilities.



Putting more terminals on-line in individual networks means better results for users. Main-memory upgrades in 1979 increased System IV/90 memory capacity to 480,000 bytes—five times that available several years ago. Depending on the application, this means that up to three times as many Four-Phase terminals can be in use on one system without degrading individual response times. Also, greater memory capacity allows the System IV/90 to support up to five distinct software packages under MFE/IV, the Multifunction Executive. Each package may be addressed independently and concurrently by any operator. This dynamic allocation of resources results in a significant increase in operator and system productivity and is a major advantage of MFE/IV.

More distributed processing power at lower cost is exemplified by our new Systems IV/60 and IV/65, announced in 1979. These mid-range processors feature expanded main memory capacity, high processing speeds and the ability to operate under Multifunction Executive software. Utilizing System IV/90 technology, the new processors are compatible with existing Four-Phase software. This makes it possible for customers to upgrade from smaller processors and to add multiple functions when only one function was previously performed. A preponderance of System IV/60 and IV/65 customer orders have included MFE/IV, reflective of the trend in our market.

*The Pacific Stock Exchange generates the greatest volume of shares traded on any exchange outside of New York City, and has experienced substantial growth in volume over the past several years. The Exchange pioneered progressive securities processing applications to handle millions of shares daily utilizing Four-Phase distributed data processing systems and VISION for data entry, on-line inquiry, and COBOL. Stock depository activities and stock clearing activities are handled by programs developed on Four-Phase systems in San Francisco and in Los Angeles. VISION enables each location to operate independently and yet to have access to up to the minute information in the other city via its communications capabilities.*

*Members executing orders on the Exchange's Options Trading Floor use Four-Phase terminals to instantly confirm commitments to buy and sell stock options and to generate transaction tickets providing information concerning the trade. Through the use of Four-Phase systems, unique VISION applications and communications capabilities to locations such as New York, Portland and Seattle, the Exchange has been able to implement cost-saving procedures and to operate in an efficient, controlled environment.*

System reliability and software operating efficiency are fundamentally important in distributed processing networks. In recognition of that fact, over 1,000 Four-Phase personnel are engaged in field service and software support. As a result, our customers experience very high system reliability on average. The magnitude of software support is reflected in the ratio of more than 1.3 systems engineers backing up each marketing representative. In 1979, we invested heavily in both field service and systems engineering areas.



Geographic coverage by the Four-Phase field service force expanded by almost one-third in 1979 and will experience further growth in 1980. Additionally, the Field Engineering Operations Center, which was implemented in the latter half of 1979, makes it possible to utilize our field service assets, both technicians and parts, more efficiently. This is resulting in improved responsiveness to customers' requirements and a gain in productivity. The information gathering capabilities of the Operations Center also allow the Company to spot emerging trends quickly and take appropriate action at an early stage.

Over 300 million operator hours in arduous and diverse environments have honed and refined the Company's operating software. It is this aggregate experience that has made the Multifunction Executive such a successful concept. MFE/IV allows the simultaneous operation of separate computer programs, each of which has been field proven.

Our reservoir of software expertise is a vital corporate asset and one which we build through extensive systems engineering support. The skilled, highly-trained software specialists in the field have available to them a support staff of senior personnel and remote diagnostic capabilities. Software specialists work closely with our customers to plan their networks, to implement software packages and to provide guidance on customer program development.

*Dominion Textile Inc., Canada's largest textile producer, has smoothly integrated Four-Phase computers into a sophisticated multi-division distributed data processing network servicing plants, sales offices and distribution centers.*

*At the Magog, Quebec, finishing plant where up to 3 million yards of fabric are processed weekly, System IV/90 computers track fabric through up to 17 separate processes as it is bleached, dyed, printed and finished to meet 25,000 different product requirements. Production exceptions, such as problem lots, are monitored and reported as they occur, enabling Domtex to reduce production costs. Magog's operating management is alerted to any variance in shipment requirements and schedules so that effective changes can be made in production schedules. Dominion Textile enjoys a high return on investment from Four-Phase on-line processing capabilities through reduced inventories, shorter manufacturing cycles, faster shipments and invoicing and greater customer satisfaction.*

Over 3,400 individuals comprised our personnel resources at year-end 1979, an increase of almost one-quarter over the year earlier level. Investing in the future of our employees is an area of continuing and increasing emphasis. It is the Company's goal to obtain the most efficient and productive work force feasible and to encourage and support individuals in their quest for personal growth.

The range and scope of training and education programs within Four-Phase has been significantly increased in response to the development requirements of the Company and the evolving sophistication of our product. Reflective of this, we have transferred the Field Engineering Training Center from our Cupertino manufacturing and administration complex to a new and considerably larger site in Dallas, Texas. Field engineering and systems engineering personnel both receive intensive training which is reinforced by frequent updating. This instruction utilizes advanced techniques coupled with practical, hands-on experience and performance monitoring. Student days of field engineering and systems engineering education will rise significantly in 1980, providing the basis for continued excellence in field support.

A range of technical and supervisory education programs enable our employees to acquire new skills and to grow and enlarge their capabilities in response to the needs of an expanding organization. This opportunity is critical to the individual as well as to the Company, and Four-Phase has committed appropriate resources to the area. Our innovative managerial development curriculum is practical and results-oriented. Through it hundreds of employees have gained and refined their supervisory and management skills. It is programs such as this that will build the pool of talented and trained individuals needed to meet the Company's growth requirements.



*Union Carbide is among the nation's 25 largest industrial companies. Although generally classified as a chemical company, Union Carbide is uniquely diversified among chemicals, gases, metals, carbons, consumer and specialty products.*

*Four-Phase distributed processing systems serve Union Carbide information management requirements in such diverse settings as the corporate headquarters, the Home and Automotive Division and the Linde Division.*

*Union Carbide's Linde Division manufactures industrial gases at over 125 plants nationwide. Four-Phase System IV/90's in regional locations enter, track and process the information vital to managing this complex business. The present System IV/90 equipment was preceded by smaller System IV/40's and then System IV/70's, reflecting the ease of upgrading among Four-Phase products and the increasing number of Linde applications. Using Four-Phase data entry, on-line inquiry and COBOL processing capabilities, Linde management has obtained significant improvements in production planning and customer invoicing.*

New manufacturing control systems are being introduced to improve production efficiency. These systems represent a substantial investment and they will enable us to increase factory productivity, manage parts and work-in-progress inventories more effectively, and serve customers with shorter lead times on systems orders that have become progressively more complex. In 1979 Four-Phase began development of a data-base-management system which, when fully implemented, will permit us to establish an integrated manufacturing management information system.



Better, more reliable Four-Phase hardware produced more efficiently at lower cost will result. The new system will integrate manufacturing information flow, from orders received to bills of material, inventory control, purchasing, planning and scheduling, cost accounting and operations management. It will interface with marketing, shipping, accounts payable and receivable and purchasing.

Raising productivity throughout the manufacturing process is one of our primary objectives. To that end, we are planning and installing new automated manufacturing processes. A multi-million dollar investment has already included new tooling, fixturing, processing and material selection for key parts. Automatic parts-insertion equipment is automating the placement of components on printed-circuit boards. Board design is being refined and automated through our own computer-aided-design capabilities.

Facilities expansion and capital projects mirror our expectations of growth and our investment in productivity enhancing programs. New facilities construction initiated in 1979 centered on Building 5 in our Cupertino manufacturing and administrative complex. This 210,000 square-foot office building is scheduled for completion in the spring of 1981, at which time Cupertino square footage will total 790,000. Occupancy of Building 5 will allow manufacturing operations to expand within the present four contiguous buildings.

*9:25 A.M. Customer telephones service request to Field Engineering Operations Center. Using the system identification number, operator obtains information from the Center's comprehensive data base regarding customer name, address, specific system location and configuration. Data are verified and details of the service request are noted and added to the file for reference by dispatcher.*

*9:30 A.M. Regional dispatcher in the Operations Center contacts appropriate field service personnel, apprising the technician of the nature of the request. Up to date service history is available.*

*9:35 A.M. Assigned field engineer informs customer that service is on the way.*

*10:30 A.M. Field engineer arrives at site fully briefed regarding service need and location history.*

*11:30 A.M. Service completed. Field engineer telephones details to Operations Center. Center updates customer files, site history and parts usage data. Information is stored for further use in performance measurement.*


ENGINE
OPERATIONS

## Financial Review



**Operations.** Financial results in 1979 posted strong gains in revenue, net income and net income per share when compared with 1978 figures. These increases resulted primarily from a growth in shipments, incremental additions to the Company-owned pool of equipment leased to customers and improved operating efficiencies.

Fourth quarter 1979 revenues of $52,360,000 placed the Company at an annualized revenue rate exceeding $200 million. This doubles the level posted in the comparable quarter just two years earlier.

Lease and service revenues in 1979 comprised the Company's most significant component of revenues at 36.4% of total. This revenue stream, which expands as a consequence of additions to the Company's base of leased equipment, has historically exhibited a pattern of year-to-year advances. In 1979, lease and service revenue increased by 32.1% over that recorded in 1978.

Four-Phase derives sales revenues from several sources: sales to end-users, independent leasing companies, international distributors and original equipment manufacturers and long-term lease contracts accorded sales accounting treatment. Sales revenues advanced 31.6% in 1979 compared with the prior year.

The Company focused its efforts in 1979 on controlling the growth of operating expenses. Expenses in each functional area rose less rapidly than revenues, and total operating expense rose only 20.7%, equaling just 46.4% of revenues compared with 50.7% in 1978. This more than offset a decline in the gross profit margin attendant to a shift in the mix of sales revenues and higher component costs. As a result, operating income, income before income taxes and net income all rose as a percentage of revenues in the year.

**Financial Position.** During 1979 we took several actions to assure the availability of sufficient capital to fund our growth and to retain maximum flexibility in our capital structure so as to be able to respond to changing conditions and requirements.

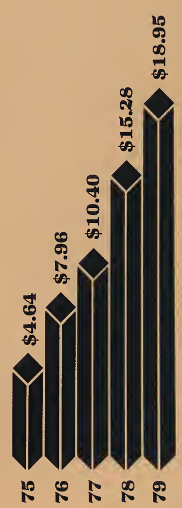
The rapid growth in funds generated from operations and depreciation was evident again in 1979, as the $37,839,000 from that source was 36.6% greater than the $27,706,000 figure for 1978 and more than double that posted in 1977. Net funds provided from operations was $9,799,000 in 1979 compared with a net use of $8,316,000 the prior year.

The positive cash flow from operations coupled with close control of working capital items and issuances of common stock, primarily from employee stock plans, resulted in stockholders' investment again increasing as a portion of capitalization. The ratio of stockholders' investment to long-term debt reached 2.5:1 at year end, having stood at 1.5:1 as recently as the end of 1977.

We also enhanced our financial position by entering into a new revolving credit/term loan agreement with our bank lending group. Of material interest in the new agreement is the improved formula for establishing the effective interest rate. This has proved of substantial benefit to the Company in the present period of high rates. The agreement also contains a provision allowing the Company to borrow up to $10,000,000 under other credit facilities which are typically at costs lower than the commercial bank prime lending rates. We have been able to utilize this alternative to reduce overall interest costs to the Company.


**Assets**
(Thousands)


**Stockholders' Investment**
(Thousands)




**Stockholders' Investment Per Share**

The Company's philosophy regarding the use of debt is that a well-managed concern should take advantage of external funds to enhance return on stockholders' investment. In viewing our capital structure, it is important to consider that debt is in large part covered by the committed revenues from lease contracts.

The Company's return on average stockholders' investment was 19.9% in 1979, considerably above the average in either our industry or in the broader spectrum of manufacturing concerns. Due to the continued demand for funds to fuel our growth, we have followed a course of foregoing dividends and reinvesting all internally generated funds. That strategy appears to be appropriate within our view of the distributed processing industry's potential long-term growth rate.

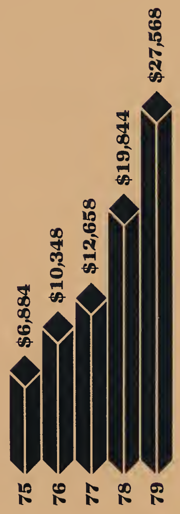
Four-Phase, since its inception, has utilized conservative accounting policies. This strategy stems from the Company's focus on long-term growth and quality of earnings. In this regard, we have always expensed lease acquisition, product refurbishment and research and development costs. Moreover, Company-manufactured equipment utilized in operations is capitalized and depreciated in the same manner as equipment for lease. Additionally, we have consistently implemented mandated changes in financial accounting standards at the earliest opportunity. We therefore view the Company's financial statements as being conservatively stated. We intend to maintain such high standards in the future.

**Nonconsolidated Finance Subsidiaries.** At year-end 1979, the Company's nonconsolidated finance subsidiaries held $70,975,000 in assets, an increase of 46.2% over comparable 1978 assets of $48,548,000. This growth reflects a continued increase in revenues resulting from long-term lease contracts, where the lease receivables are purchased by the finance subsidiaries.

Our financing strategy for the finance subsidiaries, none of whose debt is guaranteed by the parent, has been periodically to fund out revolving bank notes with long-term financing. This we accomplished in the spring of 1979 with a private placement of 10.25% Senior Notes to four insurance companies. At present the subsidiaries have placed $30,000,000 in Senior Notes at a weighted interest rate of 9.9%, considerably below the level of current revolving credit interest rates.

In 1979, the Company established a captive insurance company as part of its risk management programs. This vehicle provides the Company direct access to the world-wide reinsurance market, which should enable us to achieve improved insurance coverage at lower costs.

**Outlook.** Four-Phase has in place a solid financial structure. Our capitalization is appropriate to our operations, cash flow is strong and improving and assets are of high quality. We view the onset of the 1980's with confidence in the strength of our financial posture and in our flexibility to respond positively to the challenges that lie ahead.




**Income From Operations**
(Thousands)


**Equipment for Lease**
(Thousands)


**Net Income as a Percentage of Revenue**
(Before Extraordinary Credit)

# Five-Year Summary of Operations



| | 1979 | 1978 | 1977 | 1976 | 1975 |
|---|---|---|---|---|---|
| | (In thousands except per share data) | | | | |
| **Revenues** | **$178,736** | **$135,647** | **$88,508** | **$63,218** | **$50,150** |
| Sales | 113,722 | 86,426 | 52,978 | 37,978 | 30,797 |
| Lease and service | 65,014 | 49,221 | 35,530 | 25,240 | 19,353 |
| **Costs and expenses** | | | | | |
| Cost of sales | 48,795 | 30,920 | 20,005 | 15,069 | 13,833 |
| Cost of lease revenue | 19,366 | 16,099 | 10,664 | 8,329 | 5,353 |
| Field service | 29,371 | 23,196 | 14,885 | 10,049 | 9,252 |
| Marketing | 32,631 | 28,210 | 19,226 | 12,172 | 9,398 |
| Research and development | 11,448 | 9,291 | 6,322 | 4,137 | 2,706 |
| General and administrative | 9,557 | 8,087 | 4,748 | 3,114 | 2,724 |
| **Income from operations** | **27,568** | **19,844** | **12,658** | **10,348** | **6,884** |
| Financing expense, net | (4,478) | (3,769) | (1,591) | (2,200) | (3,873) |
| Other income (expense), net | (179) | 631 | 246 | (72) | (166) |
| **Income before income taxes** | **22,911** | **16,706** | **11,313** | **8,076** | **2,845** |
| Provision for income taxes | 6,184 | 4,510 | 3,960 | 3,690 | 1,256 |
| **Income before extraordinary credit** | **16,727** | **12,196** | **7,353** | **4,386** | **1,589** |
| Extraordinary credit | — | — | 1,790 | 3,090 | 1,066 |
| Net income | 16,727 | 12,196 | 9,143 | 7,476 | 2,655 |
| Average shares—primary | 5,082 | 4,682 | 3,978 | 2,517 | 976 |
| Average shares—fully diluted | 5,145 | 4,734 | 4,228 | 3,650 | 2,964 |
| Income per share, primary | $ 3.29 | $ 2.60 | $ 1.85* | $ 1.67* | $ 1.16* |
| **Income per share, fully diluted** | **3.25** | **2.58** | **1.76*** | **1.31*** | **.74*** |
| **Financial Position** | | | | | |
| Equipment for lease— | | | | | |
| Gross | $103,078 | $ 80,887 | $53,050 | $36,381 | $29,579 |
| Net | 60,131 | 51,935 | 34,048 | 23,372 | 20,806 |
| Long-term debt | 37,884 | 31,895 | 26,993 | 29,540 | 38,500 |
| Stockholders' investment | 94,804 | 73,171 | 41,355 | 30,701 | 4,282 |
| Total assets | 165,965 | 129,635 | 85,067 | 68,259 | 51,299 |
| **Statistics** | | | | | |
| Income as a percentage of revenues | 9% | 9% | 8%* | 7%* | 3%* |
| Stockholders' investment as a percentage of capitalization | 71% | 70% | 61% | 51% | 10% |
| Stockholders' investment per share | $ 18.95 | $ 15.28 | $ 10.40 | $ 7.96 | $ 4.64 |
| Current ratio | 2.7:1 | 2.5:1 | 2.1:1 | 3.6:1 | 2.0:1 |
| Employees | 3,422 | 2,800 | 2,130 | 1,415 | 1,108 |

*Before extraordinary credit

## Management's Discussion and Analysis of Operations



### 1979 Compared to 1978

**Revenues.** Compared with prior year figures, 1979 revenues rose 31.8% or $43.1 million. Lease and service revenues increased 32.1% or $15.8 million and sales revenues advanced 31.6% or $27.3 million. These increases resulted from additions to Company-owned equipment leased to customers as well as higher unit shipments for sale. Lease and service revenues comprised 36.4% of total revenues in 1979 compared with 36.3% in 1978. Long-term leases accorded sales accounting treatment increased 31.6% in 1979 and contributed 23.7% of total revenues, while end-user sales decreased by 1.5% and comprised 16.5% of total revenues. Sales to international distributors and OEMs rose by 72.8% and contributed 11.9% of total revenues, while sales to independent leasing companies increased 72.2% and equaled 11.5% of total revenues. The Company anticipates a moderation in the rate of revenue growth in 1980.

**Costs and Expenses.** Higher costs for certain components, occasioned by high industry-wide demand in 1979, in conjunction with a shift in the mix of sales revenue resulted in an increase in the cost of sales and lease revenue of 45.0% or $21.1 million. Gross income as a percentage of revenues was 61.9% in 1979 and 65.3% in 1978.

Each segment of operating expenses declined in 1979 as a percentage of revenues when compared with 1978 figures. In total, operating expenses rose 20.7% or $14.2 million compared with the increase in revenues of 31.8%. As a result, operating expenses as a percentage of revenues equaled 46.4% in 1979 compared with 50.7% a year earlier. This improvement derived from personnel efficiencies as well as control of operating expenditures. The possibility of further improvement in 1980 is dependent upon the rate of growth in revenue. Income from operations rose by 38.9% or $7.7 million and was equal to 15.4% of revenues in 1979 compared with 14.6% in 1978.

Net financing expense rose 18.8% or $.7 million in 1979. Lower utilization of credit facilities in the earlier part of the year and improved terms under the revolving credit agreement offset in large part the increase in rates and higher utilization experienced in the latter half of the year. Other income (expense) consists primarily of currency related gains or losses and reflected a net expense in 1979 compared with income the prior year.

**Income.** A gain in 1979 income before income taxes of 37.1%, or $6.2 million, reflected greater revenues and higher operating income as a percentage of revenues. Reduced operating expense ratios more than offset higher product costs. Income before income taxes was 12.8% of revenues compared with 12.3% in 1978.

Net income rose in parallel with income before taxes as taxes were held stable at 27.0% of income for both years. Net income increased 37.2%, or $4.5 million, from prior year figures and equaled 9.4% of revenues compared with 9.0% in 1978. Net income in 1980 is likely to reflect the impact of a recessionary economic environment.

### 1978 Compared to 1977

**Revenues.** Consolidated 1978 revenues compared to 1977 increased 53.3% or $47.1 million. Sales revenues registered a 63.1% or $33.4 million gain and lease and service revenues rose 38.5% or $13.7 million. Lease and service revenues represented 36.3% of consolidated revenues in 1978 compared to 40.1% in 1977. Sales to end-users and long-term leases accorded sales accounting treatment posted 91.7% and 86.6% increases respectively in 1978 relative to 1977. Distributor and OEM sales increased 86.1% and sales to independent leasing companies, which are made at the Company's option, decreased slightly.

**Costs and Expenses.** The 1978 cost of sales and leasing operations increased 53.3% or $16.4 million over 1977, in parallel with the rise in revenues. Thus, the gross margin on revenues was 65.3% in both years.

Operating expenses in 1978 increased by 52.2% or $23.6 million, slightly less than the revenue advance. Operating income, as a consequence, increased 56.8% or $7.2 million year to year, equaling 14.6% of revenues in 1978 compared to 14.3% in 1977. The increase in expenses generally reflected increased operating levels.

Net financing expense more than doubled year to year as a result of greater utilization of the Company's credit facilities and higher interest rates. The increase in net financing expense was partially offset by other income, primarily translation gains.

**Income.** Income before income taxes increased 47.7% or $5.4 million in 1978, a gain resulting primarily from higher revenue levels. Somewhat higher operating margins at 14.6%, compared with 14.3% the prior year, were offset by increases in net financing expense, so that income before taxes equaled 12.3% in 1978, a slight decrease from 12.8% posted in 1977. Taxes in 1978 were accrued at a 27.0% rate compared with 35.0% the prior year. The lower rate resulted largely from increased investment tax credits and the effect of international operating losses previously not deductible for tax purposes.

Higher income before taxes in conjunction with a reduced tax rate enabled 1978 income to increase 65.9% or $4.8 million over 1977 income before extraordinary credit. Income in 1978 equaled 9.0% of revenues compared with 8.3% the prior year.

# Consolidated Statement of Income

| Year Ended December 31, | 1979 | 1978 |
| --- | --- | --- |
| | (In thousands except share data) | |
| **Revenues:** | | |
| Sales | $ 113,722 | $ 86,426 |
| Lease and service | 65,014 | 49,221 |
| | 178,736 | 135,647 |
| **Costs and expenses:** | | |
| Cost of sales | 48,795 | 30,920 |
| Cost of lease revenue | 19,366 | 16,099 |
| Field service | 29,371 | 23,196 |
| Marketing | 32,631 | 28,210 |
| Research and development | 11,448 | 9,291 |
| General and administrative | 9,557 | 8,087 |
| | 151,168 | 115,803 |
| **Income from operations** | 27,568 | 19,844 |
| Financing expense, net (Note 4) | (4,478) | (3,769) |
| Other income (expense), net | ( 179) | 631 |
| **Income before income taxes** | 22,911 | 16,706 |
| Provision for income taxes (Note 5) | 6,184 | 4,510 |
| **Net income** | $ 16,727 | $ 12,196 |
| **Net income per common and common equivalent share** | $ 3.29 | $ 2.60 |
| Average common and common equivalent shares | 5,082,190 | 4,682,274 |
| **Net income per common share assuming full dilution** | $ 3.25 | $ 2.58 |
| Average common shares assuming full dilution | 5,144,965 | 4,733,891 |

The accompanying accounting policies and notes are an integral part of these consolidated financial statements.

Four-Phase Systems, Inc. and Consolidated Subsidiaries

# Consolidated Balance Sheet

| December 31, | 1979 | 1978 |
|---|---|---|
| | (In thousands except share data) | |
| **Assets** | | |
| **Current assets:** | | |
| Cash | $ 3,843 | $ 4,972 |
| Accounts receivable, net of allowance for doubtful accounts of $800 in 1979 and $600 in 1978 | 24,753 | 18,031 |
| Inventories (Note 6) | 39,569 | 26,302 |
| Prepaid expenses | 1,477 | 1,562 |
| *Total current assets* | 69,642 | 50,867 |
| **Equipment for lease** (Note 7) | 103,078 | 80,887 |
| Less accumulated depreciation | (42,947) | (28,952) |
| | 60,131 | 51,935 |
| **Property and equipment** (Note 8) | 28,982 | 24,069 |
| Less accumulated depreciation and amortization | (13,178) | (9,415) |
| | 15,804 | 14,654 |
| **Investment in and advances to nonconsolidated finance subsidiaries** (Note 9) | 19,600 | 11,765 |
| **Other assets** | 788 | 414 |
| | $165,965 | $129,635 |
| **Liabilities and stockholders' investment** | | |
| **Current liabilities:** | | |
| Notes payable to banks (Note 10) | $ 3,286 | $ 3,608 |
| Accounts payable | 9,904 | 5,088 |
| Income taxes payable (Note 5) | 1,504 | 1,909 |
| Accrued liabilities | 11,478 | 9,651 |
| *Total current liabilities* | 26,172 | 20,256 |
| **Deferred income taxes** (Note 5) | 7,105 | 3,354 |
| **Other liabilities** | — | 959 |
| **Long-term debt** (Note 10): | | |
| Notes payable to banks | 33,570 | 28,064 |
| Capital lease obligations | 4,314 | 3,831 |
| *Total long-term debt* | 37,884 | 31,895 |
| **Stockholders' investment** (Notes 11 and 12): | | |
| Preferred stock, par value $10.00 per share—authorized—100,000 shares; none outstanding | — | — |
| Common stock, par value $.04 per share—authorized—8,000,000 shares; outstanding—5,003,431 shares in 1979 and 4,789,659 shares in 1978 | 200 | 191 |
| Capital in excess of par value | 58,009 | 53,112 |
| Retained earnings | 36,595 | 19,868 |
| *Total stockholders' investment* | 94,804 | 73,171 |
| | $165,965 | $129,635 |

The accompanying accounting policies and notes are an integral part of these consolidated financial statements.

Four-Phase Systems, Inc. and Consolidated Subsidiaries

# Consolidated Statement of Changes in Financial Position



| Year Ended December 31, | 1979 | 1978 |
|---|---|---|
| | (In thousands) | |
| **Funds provided from (used for) operations:** | | |
| Net income | **$ 16,727** | $ 12,196 |
| Expenses not requiring working capital— | | |
| Depreciation of equipment for lease | **16,921** | 12,214 |
| Depreciation and amortization of property and equipment | **4,191** | 3,296 |
| Deferred income taxes and other, net | **2,844** | 3,357 |
| | **40,683** | 31,063 |
| Investment in— | | |
| Equipment for lease | **(25,117)** | (30,101) |
| Property and equipment | **( 5,341)** | ( 9,123) |
| Other assets | **( 426)** | ( 155) |
| | **(30,884)** | (39,379) |
| *Net funds provided from (used for) operations* | **9,799** | ( 8,316) |
| **Funds provided from (used for) financing activities:** | | |
| Investments in and advances to nonconsolidated finance subsidiaries | **( 7,835)** | ( 2,918) |
| Long-term debt— | | |
| Long-term borrowings | **2,388** | 8,702 |
| Transfers from (to) current portion | **3,118** | ( 3,118) |
| Increase in capital lease obligations | **483** | 1,358 |
| Conversion of 9% Convertible Subordinated Notes | **—** | ( 2,040) |
| | **5,989** | 4,902 |
| Issuance of Common Stock from— | | |
| Purchases under employee stock plans | **4,231** | 3,018 |
| Common Stock warrant exercised | **675** | — |
| Underwritten public offering | **—** | 14,615 |
| Conversion of 9% Convertible Subordinated Notes | **—** | 1,987 |
| | **4,906** | 19,620 |
| *Net funds provided from financing activities* | **3,060** | 21,604 |
| **Increase in working capital** | **$ 12,859** | $ 13,288 |
| **Analysis of changes in working capital:** | | |
| Increase (decrease) in current assets— | | |
| Cash | **$( 1,129)** | $ 2,725 |
| Accounts receivable | **6,722** | 5,621 |
| Inventories | **13,267** | 8,796 |
| Prepaid expenses | **( 85)** | 680 |
| | **18,775** | 17,822 |
| Increase (decrease) in current liabilities— | | |
| Notes payable to banks | **( 322)** | 2,129 |
| Accounts payable | **4,816** | ( 1,938) |
| Income taxes payable | **( 405)** | 629 |
| Accrued liabilities | **1,827** | 3,714 |
| | **5,916** | 4,534 |
| **Increase in working capital** | **$ 12,859** | $ 13,288 |

The accompanying accounting policies and notes are an integral part of these consolidated financial statements.

Four-Phase Systems, Inc. and Consolidated Subsidiaries

## Consolidated Statement of Stockholders' Investment

| | Common Stock | | Capital in Excess of Par Value | Retained Earnings | Total Stockholders' Investment |
|---|---|---|---|---|---|
| | Shares | Amount | | | |
| | (In thousands except share data) | | | | |
| **Balance, December 31, 1977** | 3,974,702 | $159 | $33,524 | $ 7,672 | $41,355 |
| Net income | | | | 12,196 | 12,196 |
| Underwritten public offering of Common Stock | 500,000 | 20 | 14,595 | | 14,615 |
| Conversion of 9% Convertible Subordinated Notes | 156,920 | 6 | 1,981 | | 1,987 |
| Issuance of Common Stock for stock plans— | | | | | |
| Employee stock option plans | 80,385 | 3 | 969 | | 972 |
| Employee Stock Purchase Plan | 72,217 | 3 | 1,300 | | 1,303 |
| Tax Reduction Act Stock Ownership Plan | 5,435 | — | 223 | | 223 |
| Tax benefit from employee stock plans transactions | | | 520 | | 520 |
| **Balance, December 31, 1978** | 4,789,659 | 191 | 53,112 | 19,868 | 73,171 |
| Net income | | | | 16,727 | 16,727 |
| Common Stock warrant exercised | 38,726 | 2 | 673 | | 675 |
| Issuance of Common Stock for stock plans— | | | | | |
| Employee stock option plans | 91,537 | 4 | 1,151 | | 1,155 |
| Employee Stock Purchase Plan | 72,200 | 3 | 1,972 | | 1,975 |
| Tax Reduction Act Stock Ownership Plan | 11,309 | — | 411 | | 411 |
| Tax benefit from employee stock plans transactions | | | 690 | | 690 |
| **Balance, December 31, 1979** | 5,003,431 | $200 | $58,009 | $36,595 | $94,804 |

The accompanying accounting policies and notes are an integral part of these consolidated financial statements.

## Summary of Significant Accounting Policies



**Principles of consolidation.** The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries, except for finance subsidiaries whose financial operations are dissimilar to manufacturing operations. All significant intercompany accounts and transactions are eliminated.

**Accounting for revenues.** The Company leases its products to end-users and distributors under one-year, three-year, three and one-half year and five-year contracts, and sells its products to end-users, distributors, original equipment manufacturers and independent leasing companies. Except for certain long-term leases, lease revenue is accounted for under the operating method, whereby revenue is recorded as it is earned over the terms of the leases. The Company services and maintains equipment leased to customers and has provided for the cost of maintenance in all lease prices.

The present value of the minimum lease payments (net of estimated maintenance and other executory costs) from long-term leases is recorded as a sale if such present value is equal to or greater than 90% of the Company's normal selling price of the equipment, and if certain other conditions are met. Cost of sales is reduced by the present value of the estimated residual value of the equipment. Customer obligations related to long-term leases recorded as sales are subsequently sold to the Company's wholly owned finance subsidiaries at net carrying value.

**Nonconsolidated finance subsidiaries.** The nonconsolidated finance subsidiaries purchase customer obligations under long-term leases from the Company and its Canadian subsidiary for the present value of the minimum lease payments. Interest income is deferred and recognized over the terms of the customer obligations by the finance subsidiaries in proportion to the remaining unpaid principal balance. The Company pays a fee to the finance subsidiaries based upon the finance subsidiaries' expenses in relation to interest income.

Investments in the nonconsolidated finance subsidiaries are accounted for by the equity method. In the Consolidated Statement of Income, the income before income taxes of the nonconsolidated finance subsidiaries is reduced by fees paid by the Company to those subsidiaries. The subsidiaries' income taxes are included in the consolidated provision for income taxes.

**International operations.** Inventory, equipment for lease and property and equipment are translated into U.S. dollars at the rates of exchange in effect when acquired. All other assets and liabilities are translated at the rate of exchange in effect at the close of the period. Revenue and expense accounts are translated at average rates of exchange prevailing during the year, except for depreciation which is translated at the rates of exchange which were in effect when the respective assets were acquired. Exchange gains and losses are included in other income.

**Inventories.** Inventories are stated at the lower of average cost, which consists of material, manufacturing labor and related overhead expenses, or market.

**Equipment for lease.** Manufacturing costs of equipment for lease and spare parts are capitalized and depreciated using the straight-line method over five years continuously to zero residual value. Depreciation of leased equipment commences with the first full month of revenue. Spare parts are depreciated commencing with the first full month after the parts are shipped to field operations. Labor, material and overhead costs associated with refurbishing and maintaining equipment are expensed as incurred. Lease acquisition and equipment installation costs are also expensed as incurred.

**Property and equipment.** Property and equipment is stated at cost and depreciated or amortized over the estimated useful lives of the assets using the straight-line method. Company-manufactured equipment utilized in Company operations is capitalized when it is placed in service and depreciated in the same manner as equipment for lease. Estimated useful lives are:

| | |
|---|---|
| Machinery and equipment | 4-8 years |
| Office furniture and fixtures | 8 years |
| Leasehold improvements | Term of lease |

Expenditures for maintenance and repairs of equipment are expensed as incurred and betterments are capitalized. Capital leases are recorded at the present value of the lease obligations. Gains or losses on dispositions are included in income.

**Investment tax credit.** Investment tax credits are recognized under the flow-through method as a reduction of the provision for income taxes.

**Net income per common share.** Net income per common and common equivalent share is computed by dividing net income by the weighted average number of common and common equivalent shares (stock options and warrants) outstanding during the period. Net income per share assuming full dilution is computed after further adjustment for the effect of using the year-end market price per share of stock in determining the dilutive effect of common equivalents. In 1978, the fully diluted computation was also affected by the shares issuable upon conversion of the 9% Convertible Subordinated Notes.

# Notes to Consolidated Financial Statements



## 1. BUSINESS SEGMENTS

The Company is engaged in the business of developing, manufacturing, marketing and servicing distributed data processing systems. No separate class of similar products or services contributed more than 10% to revenues. Sales to one customer accounted for approximately $17.9 million (10%) of consolidated revenues in 1979 and $8.0 million (6%) in 1978. Aggregate export sales, primarily to Europe, accounted for approximately $21.3 million (12%) of consolidated revenues in 1979 and $12.3 million (9%) in 1978.

## 2. LEASE REVENUES

Minimum future lease revenues on the Company's equipment for lease under noncancellable operating leases at December 31, 1979 are due as follows:

| | (In thousands) |
|---|---|
| 1980 | $23,543 |
| 1981 | 4,967 |
| 1982 | 2,459 |
| 1983 | 663 |
| 1984 | 157 |
| | $31,789 |

## 3. LEASE COMMITMENTS

The Company leases its facilities and certain equipment under various operating leases expiring at various dates through 2001. Certain real estate leases contain renewal options and provisions adjusting the lease payments for increases in the consumer price index. Rental expense was $6,268,000 for 1979 and $5,163,000 for 1978. Total rental commitments at December 31, 1979 are as follows:

| Year Ending December 31, | Real Estate | Equipment |
|---|---|---|
| | (In thousands) | |
| 1980 | $ 5,078 | $332 |
| 1981 | 6,358 | 231 |
| 1982 | 5,826 | 116 |
| 1983 | 4,746 | — |
| 1984 | 4,470 | — |
| 1985-2001 | 58,958 | — |
| | $85,436 | $679 |

## 4. FINANCING EXPENSE

Financing expense consists of the following:

| | 1979 | 1978 |
|---|---|---|
| | (In thousands) | |
| Interest expense | $(4,911) | $(4,332) |
| Interest income | 377 | 206 |
| Income from nonconsolidated finance subsidiaries | 56 | 357 |
| | $(4,478) | $(3,769) |

## 5. INCOME TAXES

The provision for income taxes consists of:

| | 1979 | 1978 |
|---|---|---|
| | (In thousands) | |
| Currently payable— | | |
| Federal | $ 1,547 | $ 1,204 |
| State and foreign | 459 | 183 |
| Deferred— | | |
| Federal | 2,687 | 2,112 |
| State | 1,334 | 797 |
| Foreign | 157 | 214 |
| Provision for income taxes | $ 6,184 | $ 4,510 |



Deferred taxes are provided for timing differences between financial and tax earnings. The tax effects of major timing differences in 1979 and 1978 are as follows:

| | 1979 | 1978 |
|---|---|---|
| | (In thousands) | |
| Differing methods in recognition of income from long-term lease of equipment | $ 4,723 | $ 11,087 |
| Differing methods in recognition of income on disposition of equipment for lease | 4,263 | 1,444 |
| Tax depreciation in excess of (less than) book depreciation | 776 | (3,408) |
| Difference in recognition of intercompany profits | 326 | (734) |
| Investment tax credits recognized as a reduction in deferred taxes | (1,810) | (1,868) |
| Differing methods of accounting for certain research and development costs | (2,409) | (3,128) |
| Accounting reserves not deductible for tax purposes | (785) | (629) |
| Differing methods in recognition of Stock Appreciation Rights | 537 | (346) |
| Differing methods in recognition of certain interest expense | (1,770) | — |
| Other, net | 327 | 705 |
| Total timing differences | $ 4,178 | $ 3,123 |

The combined effective federal, state and foreign income tax rate differs from the U.S. federal statutory rate as follows:

| | 1979 | | 1978 | |
|---|---|---|---|---|
| | (In thousands) | | | |
| Tax at statutory rate | $ 10,539 | 46% | $ 8,019 | 48% |
| Investment tax credit | (4,544) | (20) | (2,730) | (16) |
| Tax effect of DISC income | (868) | (4) | (750) | (5) |
| Tax effect of losses from international subsidiaries | (223) | (1) | (888) | (5) |
| State income taxes, net of federal income tax effect | 949 | 4 | 647 | 4 |
| Other, net | 331 | 2 | 212 | 1 |
| Provision for income taxes | $ 6,184 | 27% | $ 4,510 | 27% |

At December 31, 1979, the cumulative amount of Domestic International Sales Corporation (DISC) income for which there has been no provision for federal income taxes is $6,511,000.

No U.S. taxes have been provided for undistributed accumulated earnings of international subsidiaries because such earnings are permanently reinvested. At December 31, 1979, such earnings amount to $1,079,000.

Investment tax credits of $4,852,000, which are available to reduce future federal income tax payments, have been recognized as a reduction of deferred taxes.

**6. INVENTORIES**

Inventories are utilized in the manufacture of equipment for sale or lease. Systems are configured to customer order from standard components and are shipped after final testing; consequently, the Company maintains no inventory of finished goods. Inventories consist of:

| | 1979 | 1978 |
|---|---|---|
| | (In thousands) | |
| Purchased parts | $22,406 | $14,165 |
| Work-in-process | 17,163 | 12,137 |
| | $39,569 | $26,302 |



**7. EQUIPMENT FOR LEASE**

Included in equipment for lease are net residual values of equipment under long-term leases at December 31, 1979 and 1978 of $5,975,000 and $3,333,000, respectively.

**8. PROPERTY AND EQUIPMENT**

At December 31, 1979 and 1978, property and equipment are summarized by major classification as follows:

| | 1979 | 1978 |
|---|---|---|
| | (In thousands) | |
| Machinery and equipment | $22,444 | $18,406 |
| Office furniture and fixtures | 5,592 | 4,300 |
| Leasehold improvements | 946 | 1,363 |
| | $28,982 | $24,069 |

Included above is property and equipment at cost subject to capital leases at December 31, 1979 and 1978 of $7,426,000 and $5,946,000, respectively.

**9. NONCONSOLIDATED FINANCE SUBSIDIARIES**

Following is a summary of financial information for the Company's nonconsolidated finance subsidiaries (Four-Phase Finance, Inc. and Four-Phase Finance Ltd.).

| BALANCE SHEET | 1979 | 1978 |
|---|---|---|
| | (In thousands) | |
| Cash | $ 479 | $ 247 |
| Customer obligations | 94,550 | 64,675 |
| Less maintenance and other expenses | (15,534) | (10,464) |
| Less unearned interest income | (8,913) | (6,173) |
| | 70,103 | 48,038 |
| Other assets | 393 | 263 |
| Total assets | $ 70,975 | $ 48,548 |
| Accrued liabilities | $ 590 | $ 144 |
| Due to affiliates | 4,281 | 732 |
| Notes payable to banks | 20,785 | 16,639 |
| 9-3/4% Senior Notes due 1980-1989 | 20,000 | 20,000 |
| 10-1/4% Senior Notes due 1982-1994 | 10,000 | — |
| Stockholder's investment | 15,319 | 11,033 |
| Total liabilities and stockholder's investment | $ 70,975 | $ 48,548 |



| STATEMENT OF OPERATIONS | 1979 | 1978 |
|---|---|---|
| | (In thousands) | |
| Revenues: | | |
| Interest income | $ 5,449 | $ 3,686 |
| Amounts earned from Four-Phase Systems, Inc. | 3,427 | 2,125 |
| Total revenues | 8,876 | 5,811 |
| Interest and other expenses | 5,393 | 3,329 |
| Income before income taxes | 3,483 | 2,482 |
| Less amounts earned from Four-Phase Systems, Inc. | (3,427) | (2,125) |
| Income from nonconsolidated finance subsidiaries | $ 56 | $ 357 |

The finance subsidiaries have available a revolving credit/term loan agreement, entered into in March 1979, which provides for borrowings of $30,000,000 in U.S. currency and $10,000,000 in Canadian currency based upon a borrowing base formula related to qualifying assets. At June 30, 1981, unless the loan agreement has been renewed or extended as has previously been the practice, such borrowings will be converted into a term loan with principal repayment required in 20 equal quarterly installments commencing July 1981. Borrowings under the loan agreement are unsecured.

The Company has agreed to pay to the finance subsidiaries a monthly fee calculated to produce income equal to one and one-half times fixed charges as defined in the operating agreement between the Company and the finance subsidiaries.

## 10. DEBT OBLIGATIONS

At December 31, 1979, the scheduled maturities of the Company's debt obligations are as follows:

| Year Ending December 31, | Long-Term Notes Payable to Banks | Bank Notes | Capital Lease Obligations |
|---|---|---|---|
| | | (In thousands) | |
| 1980 | $ — | $ 3,286 | $ 1,462 |
| 1981 | 3,357 | | 1,593 |
| 1982 | 6,713 | | 1,171 |
| 1983 | 6,713 | | 994 |
| 1984 | 6,713 | | 944 |
| 1985 and beyond | 10,074 | | 969 |
| Less imputed interest | — | | (1,653) |
| Total obligations | 33,570 | 3,286 | 5,480 |
| Less current portion | — | (3,286) | (1,166) |
| Total long-term debt | $33,570 | $ — | $ 4,314 |



**Revolving credit/term loan agreement.** Under the loan agreement, entered into in March 1979, the Company and its Canadian subsidiary may borrow up to the lesser of $25,000,000 in U.S. currency and $10,000,000 in Canadian currency, or a borrowing base level, which is computed based upon committed future operating lease rentals and accounts receivable from sales. At December 31, 1979, the borrowing base level exceeded the total loans outstanding by $6,714,000. At June 30, 1981, unless the loan agreement has been renewed or extended as has previously been the practice, borrowings under the loan agreement will be converted into a term loan with principal repayment required in 20 equal quarterly installments commencing July 1981. Borrowings under the loan agreement are unsecured.

U.S. dollar borrowings under the loan agreement bear interest at 107.5% of the U.S. prime interest rate. Canadian dollar borrowings bear interest at the Canadian prime interest rate plus 1%. In addition, the Company has agreed to maintain compensating balances equal to 10% of the U.S. dollar commitment and to pay certain commitment fees.

The loan agreement contains restrictive covenants and requires the Company to maintain certain financial ratios and minimum levels of tangible net worth. It also provides that the Company may, with certain limitations, pay annual cash dividends on its Common Stock. In 1980, such dividends would be limited to $4,182,000.

In 1979, the Company's maximum borrowings under the loan agreement and previous loan agreements were $29,300,000, while average borrowings were $26,000,000. The average interest rates were 14.9% for U.S. dollar borrowings and 14.5% for Canadian dollar borrowings. Maximum borrowings in 1978 were $39,500,000 and average borrowings were $32,000,000. Average interest rates in 1978 were 11.4% in U.S. dollar borrowings and 11.2% for Canadian dollar borrowings.

**Bank notes.** At December 31, 1979, the Company had outstanding $10,000,000 of short-term promissory notes of which $6,714,000 are classified as long-term indebtedness based upon the Company's intention to refinance these amounts on a long-term basis, and its ability to do so under the Company's Revolving Credit/Term Loan Agreement. The remainder of $3,286,000 is classified as short-term bank notes.

Average month-end borrowings during 1979 were $2,900,000 and the weighted average interest rate for the year was 12.9%. The maximum amount of borrowings at any month end was $10,000,000 and the average interest rate on these borrowings at December 31, 1979 was 15.0%.

**Capital lease obligations.** Capital lease obligations relate to property and equipment acquired under capital leases.

## 11. EMPLOYEE BENEFIT PLANS

**Employee stock purchase plan.** Under this Plan, participants are eligible to contribute up to 10% of their compensation towards purchase of the Company's Common Stock at a price equal to 85% of the lower of the fair market value on the day on which a participant enters the Plan in each year or the fair market value on the day the stock is purchased. Purchases occur every three months and limits have been established on the number of shares available for purchase during any three-month period. At December 31, 1979, there remained 362,016 shares available for issuance under the Plan.

In 1979, the Company issued 72,200 shares of Common Stock at prices ranging from $25.29 to $29.22 per share under the Plan. In 1978, the Company issued 72,217 shares of Common Stock at prices ranging from $11.58 to $26.35 per share under the Plan.



**Retirement benefit plans.** The Company's non-contributory deferred profit sharing plan covers substantially all employees. Company contributions to the plan are made at the discretion of the Board of Directors and are $2,250,000 for 1979 and $1,500,000 for 1978.

The Company's Tax Reduction Act Stock Ownership Plan (TRASOP) covers substantially all employees with three years or greater service. The Company contributes to the TRASOP its Common Stock or cash to be used to purchase Common Stock equal to one percent (1%) of the amount of the Company's investment in qualified capital assets and receives a credit against its federal income taxes equal to the contribution. This credit was $410,542 in 1979 and $242,172 in 1978. At December 31, 1979, the Company has reserved 38,691 shares of its Common Stock for issuance under the TRASOP.

**Stock option plans.** Under the Company's Qualified Stock Option Plan and Employee Stock Option and Appreciation Rights Plan, options may be granted to purchase Common Stock at not less than the fair market value of the stock at the grant date. Options are exercisable at 25% per year after one year from the grant date and expire five years from the grant date. At December 31, 1979, the Company has reserved 736,470 shares of its Common Stock for issuance under these Plans. The status of options granted under these Plans is as follows:

| | Number of Shares | Option Prices: Range Per Share | Option Prices: Total | Fair Market Value at Date Granted, Exercised or Became Exercisable |
|---|---|---|---|---|
| Outstanding at December 31, 1977 | 431,596 | $11.00 to 20.00 | $ 5,872,652 | $ 5,872,652 |
| Options during 1978: | | | | |
| Granted | 13,900 | 21.88 to 44.63 | 444,645 | 444,645 |
| Exercised | (80,388) | 11.00 to 18.00 | (972,440) | 2,286,140 |
| Cancelled | (18,981) | 11.00 to 18.00 | (283,785) | |
| Outstanding at December 31, 1978 | 346,127 | 11.00 to 44.63 | 5,061,072 | 5,061,072 |
| Options during 1979: | | | | |
| Granted | 242,120 | 30.88 to 45.50 | 8,284,546 | 8,284,546 |
| Exercised | (91,543) | 11.00 to 25.75 | (1,154,881) | 3,162,659 |
| Cancelled | (29,901) | 11.00 to 33.88 | (668,863) | |
| Outstanding at December 31, 1979 | 466,803 | 11.00 to 45.50 | 11,521,874 | 11,521,874 |
| Options became exercisable during: | | | | |
| 1978 | 98,904 | 11.00 to 20.00 | 1,356,676 | 2,825,681 |
| 1979 | 74,867 | 11.00 to 44.63 | 1,128,934 | 2,734,735 |

At December 31, 1979, options to purchase 113,304 shares were exercisable. The number of shares reserved but not granted was 269,667 at December 31, 1979 and 81,885 at December 31, 1978, of which 241,511 shares were reserved under the Employee Stock Option and Appreciation Rights Plan at December 31, 1979 and 59,705 shares at December 31, 1978.

Under the Employee Stock Option and Appreciation Rights Plan, stock appreciation rights may be granted with the options. During the first quarter of 1979, all outstanding rights were rescinded and previously accrued amounts were reversed. Of the options outstanding at December 31, 1979, none had an associated stock appreciation right.

**12. COMMON STOCK**

At December 31, 1979, a warrant which expires in 1981 is outstanding for the purchase of 20,654 shares of Common Stock at $17.43 per share, as adjusted.

**13. INTERNATIONAL SUBSIDIARIES**

Summarized financial information of the Company's international subsidiaries is as follows:

| | 1979 | 1978 |
|---|---|---|
| | (In thousands) | |
| Total assets | $ 10,026 | $ 10,734 |
| Notes payable to banks, long-term | (6,856) | (4,934) |
| Other liabilities | (1,333) | (2,202) |
| Parent's investment and advances | $ 1,837 | $ 3,598 |
| Revenues | $ 13,909 | $ 9,688 |
| Net income | $ 417 | $ 18 |

Total assets include equipment for lease of $7,936,000 in 1979 and $9,110,000 in 1978. The above results include an exchange loss of $247,000 in 1979 and a gain of $405,000 in 1978.

**14. TRANSACTIONS WITH INDEPENDENT LEASING COMPANIES**

The Company had sales to independent leasing companies of $20,508,000 in 1979 and $11,906,000 in 1978. In connection with equipment sold to independent leasing companies, the Company, for a fee, has agreed to maintain and service the equipment; remarket off-lease equipment without preference; and perform various administrative services. At December 31, 1979, the independent leasing companies had remaining purchase commitments through December 1981 to purchase up to $42,100,000 of the Company's products. Sales to independent leasing companies are at the Company's option.

**15. QUARTERLY FINANCIAL INFORMATION (UNAUDITED)**

| | 1979 Quarter Ended | | | |
|---|---|---|---|---|
| | March 31 | June 30 | September 30 | December 31 |
| | (In thousands except per share data) | | | |
| Revenues | $39,977 | $40,261 | $46,138 | $52,360 |
| Income from operations | 6,253 | 6,169 | 7,018 | 8,128 |
| Net income | 3,714 | 3,956 | 4,238 | 4,819 |
| Net income per common and common equivalent share | .74 | .78 | .83 | .93 |
| Net income per common share assuming full dilution | .74 | .78 | .83 | .92 |

| | 1978 Quarter Ended | | | |
|---|---|---|---|---|
| | March 31 | June 30 | September 30 | December 31 |
| | (In thousands except per share data) | | | |
| Revenues | $29,340 | $33,559 | $33,976 | $38,772 |
| Income from operations | 4,167 | 4,721 | 5,395 | 5,561 |
| Net income | 2,582 | 2,866 | 3,283 | 3,465 |
| Net income per common and common equivalent share | .62 | .64 | .66 | .70 |
| Net income per common share assuming full dilution | .60 | .63 | .66 | .70 |

## 16. CONSTANT DOLLAR VALUATION (UNAUDITED)

In September, 1979, the Financial Accounting Standards Board issued Statement No. 33, "Financial Reporting and Changing Prices," which attempts to quantify the effects of inflation on financial operating results. Statement 33 requires the Company to state certain balance sheet and income statement categories in terms of constant dollars based upon changes reflected in the Consumer Price Index for all Urban Consumers (CPI).

In the opinion of Management, the use of the CPI inaccurately depicts the impact of inflation on the Company in that the prescribed method assumes that the Company's costs have been rising in line with general inflation. This is not the case and as a result, use of the CPI overstates the impact of inflation on the Company's operations and understates adjusted Net Income. The following statements are presented in accordance with the requirements of Statement 33.



### STATEMENT OF INCOME AS ADJUSTED FOR THE EFFECTS OF GENERAL INFLATION FOR THE YEAR ENDED DECEMBER 31, 1979

| | As Stated in the Financial Statements | Adjusted for General Inflation |
|---|---|---|
| | (In thousands) | |
| Revenues: | | |
| Sales | $113,722 | $113,722 |
| Lease and service | 65,014 | 65,014 |
| | 178,736 | 178,736 |
| Costs and expenses: | | |
| Cost of sales | 48,795 | 49,858 |
| Cost of lease revenue | 19,366 | 21,635 |
| Operating expenses | 83,007 | 83,645 |
| Financing and other expense, net | 4,657 | 4,657 |
| Income before income taxes | 22,911 | 18,941 |
| Provision for income taxes | 6,184 | 6,184 |
| Net income | $ 16,727 | $ 12,757 |
| Purchasing power gain on net monetary liabilities held during the year | | $ 4,332 |

### FIVE-YEAR COMPARISON OF SELECTED SUPPLEMENTARY FINANCIAL DATA ADJUSTED FOR EFFECTS OF GENERAL INFLATION AVERAGE 1979 DOLLARS

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 1975 | 1976 | 1977 | 1978 | 1979 |
| | (In thousands except per share amounts) | | | | |
| Revenues | $67,696 | $80,682 | $106,112 | $151,058 | $178,736 |
| Net income | | | | | $ 12,757 |
| Net income per common share assuming full dilution | | | | | $ 2.48 |
| Net assets at year-end | | | | | $ 94,551 |
| Market price per common share at year-end* | $ — | $ 21.07 | $ 26.17 | $ 32.17 | $ 44.27 |
| Average Consumer Price Index | 161.2 | 170.5 | 181.5 | 195.4 | 217.6 |

*Public trading commenced June 8, 1976.

In determining the net income amount adjusted for general inflation, the amounts as stated in the financial statements have been adjusted only for depreciation expense and the product cost component of cost of sales. Revenues and all other costs and expenses have not been restated, as it is assumed these elements reflect the average price levels for the year.

As prescribed by Statement 33, no adjustments have been made to the provision for income taxes for any deferred income taxes related to the differences between income reported on a constant dollar basis and income reported for tax purposes.

The aggregate depreciation expensed for 1979 adjusted for general inflation is $24,196,000 and compares to a historical amount of $21,112,000.

The statement requires the disclosure of the amount of purchasing power gain or loss on net monetary assets and liabilities. Monetary items are those which are fixed in terms of currency and are not dependent on future prices. In periods of inflation, the holding of net monetary assets generates a purchasing power loss. Similarly, the holding of net monetary liabilities produces a gain since the amount required to satisfy the net liability, expressed in purchasing power, decreases. The Company's purchasing power gain is based on the effect of inflation on the average balance of net monetary liabilities for the year.

Net assets in the above summary represents the sum of reported Stockholders' Investment plus the increase in inventory, property and equipment when stated in constant dollars.

No accounting policies have been changed in applying Statement 33.

## Auditors' Opinion



**To the Stockholders and the Board of Directors of Four-Phase Systems, Inc.:**

We have examined the consolidated balance sheets of Four-Phase Systems, Inc. and consolidated subsidiaries as of December 31, 1979 and 1978 and the related consolidated statements of income, stockholders' investment and changes in financial position for the years then ended. Our examinations were made in accordance with generally accepted auditing standards and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the above-mentioned consolidated financial statements present fairly the financial position of Four-Phase Systems, Inc. and consolidated subsidiaries at December 31, 1979 and 1978 and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

Deloitte Haskins & Sells

DELOITTE HASKINS & SELLS
San Francisco, California
January 23, 1980

## Common Stock Trading Range

Four-Phase Systems, Inc. common stock was listed for trading on the New York Stock Exchange on September 15, 1978 under symbol FPS. Prior to that date, trading was conducted in the over-the-counter market. Data for the earlier periods represent bid prices as reported by the National Quotation Bureau and are $0.50 below the asked prices. Subsequent data are sales prices as reported by the New York Stock Exchange. No dividends have been declared on the common stock.

| **1978** | High | Low |
|---|---|---|
| 1st Quarter | $23 | $18-1/2 |
| 2nd Quarter | 32-3/8 | 21 |
| 3rd Quarter | 46 | 28 |
| 4th Quarter | 39-7/8 | 24-1/8 |
| **1979** | | |
| 1st Quarter | $36-3/4 | $29-3/8 |
| 2nd Quarter | 37-3/4 | 32-3/4 |
| 3rd Quarter | 40-1/4 | 29-3/4 |
| 4th Quarter | 48-1/2 | 32-1/2 |

## Corporate Directory

### Officers

Lee L. Boysel
Chairman of the Board of Directors and President

John M. Clark, Jr.
Vice President—Marketing

Jack L. Faith
Vice President—Research and Development

Ronald D. Garrison
Vice President—Field Engineering

John J. La Porta
Vice President—Operations

Glen McLaughlin
Vice President—Finance and Secretary

F. Anthony Yates, Jr.
Vice President—Systems Development

R. Frederick Hodder
Treasurer

F. Judson Mitchell
Controller

### Directors



Lee L. Boysel*
Chairman of the Board of Directors and President

Christopher W. Brody**
Senior Vice President and Director
E.M. Warburg, Pincus & Co., Inc.
Specialized investment bankers

Neill H. Brownstein*
President
Neill H. Brownstein Corporation
Investment management consulting firm

Allen W. Dawson*
Executive Vice President and Director
Corning Glass Works
Manufacturer of specialty glass and related products

Philip Greer**
General Partner
Weiss, Peck & Greer
Investment management and diversified securities firm

Carl M. Vorder Bruegge**
Senior Vice President
MCI Communications, Inc.
Intercity business communications services

*Member of Compensation Committee
**Member of Audit Committee

### Transfer Agent

Morgan Guaranty Trust Company of New York, New York

### Counsel

Cooley, Godward, Castro, Huddleson & Tatum, San Francisco

### Auditors

Deloitte Haskins & Sells, San Francisco

### Corporate Offices

10700 North De Anza Boulevard, Cupertino, California 95014 Phone: (408) 255-0900

### Form 10-K

A copy of the Company's 1979 Form 10-K Annual Report as filed with the Securities and Exchange Commission, including financial statements and schedules, will be provided without charge upon request to:

Lawrence W. Roberts, Director, Investor Relations, Four-Phase Systems, Inc., 10700 North De Anza Boulevard, Cupertino, CA 95014.

### Annual Meeting

The Annual Meeting of Stockholders will be held at 3:00 P.M. local time on Tuesday, April 22, 1980 at the corporate offices in Cupertino, California.

### Sales Offices

United States
Atlanta
Baltimore
Boston
Buffalo
Charlotte
Chicago
Cincinnati
Cleveland
Columbus
Dallas
Denver
Des Moines
Detroit
Ft. Myers
Grand Rapids
Hartford
Houston
Indianapolis
Kansas City
Los Angeles
Louisville
Memphis
Miami
Milwaukee
Minneapolis
Nashville
New Orleans
New York
Newport Beach
Peoria
Philadelphia
Pittsburgh
Portland
Rochelle Park
Rochester
Sacramento
Salt Lake City
San Diego
San Francisco
San Juan, P.R.
Scottsdale
Seattle
St. Louis
Stamford
Syracuse
Tampa
Tulsa
Washington, D.C.
Wayne

Canada
Montreal
Ottawa
Toronto
Vancouver

International Distributor Locations
Argentina
Australia
Austria
Belgium
Denmark
France
West Germany
Hong Kong
Indonesia
Italy
Japan
Republic of Korea
Kuwait
Luxembourg
Malaysia
Mexico
The Netherlands
The Philippines
Saudi Arabia
Singapore
United Kingdom
Venezuela

Four-Phase Systems, Inc.



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